Nos. 03-892 and 03-907

AUG 18 2004

IN THE

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN W. BANKS, II,
Respondent.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIGITAS J. BANAITIS,
Respondent.

On Writs of Certiorari to the United States Court of Appeals for the Sixth and Ninth Circuits

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BRIEF *AMICUS CURIAE* OF THE EQUAL EMPLOYMENT ADVISORY COUNCIL IN SUPPORT OF RESPONDENTS

ANN ELIZABETH REESMAN
McGUINESS NORRIS & WILLIAMS, LLP
1015 Fifteenth Street, N.W.
Suite 1200
Washington, DC 20005
(202) 789-8600

Attorneys for *Amicus Curiae*
Equal Employment Advisory Council

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BRIEF *AMICUS CURIAE* OF THE EQUAL EMPLOYMENT ADVISORY COUNCIL IN SUPPORT OF RESPONDENTS

The Equal Employment Advisory Council respectfully submits this brief *amicus curiae* in support of Respondents John W. Banks, II and Sigitas J. Banaitis.[1] Written consent of all parties has been filed with the Clerk of the Court.

[1] Counsel for *amicus curiae* authored this brief in its entirety. No person or entity, other than the *amicus curiae*, its members, or its counsel, made a monetary contribution to the preparation of the brief.

INTEREST OF THE *AMICUS CURIAE*

The Equal Employment Advisory Council (EEAC) is a nationwide association of employers organized in 1976 to promote sound approaches to eliminating discriminatory employment practices. Its membership comprises over 330 of the nation's largest private sector corporations. EEAC's directors and officers include many of industry's leading experts in the field of equal employment opportunity. Their combined experience gives EEAC an unmatched knowledge of the practical, as well as legal ramifications of equal employment opportunity policies and requirements. EEAC's members are firmly committed to the principles of nondiscrimination and equal employment opportunity.

All of EEAC's members are employers subject to Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e *et seq.*, the Age Discrimination in Employment Act of 1967 (ADEA), 29 U.S.C. §§ 621 *et seq.*, Titles I and V of the Americans with Disabilities Act (ADA), 42 U.S.C. §§ 12101 *et seq.*, the Family and Medical Leave Act (FMLA), 29 U.S.C. §§ 2601 *et seq.*, and other employment-related statutes and regulations. As employers, as potential targets of employment discrimination charges and lawsuits, and as the ultimate sources of funds for the payment of settlements and verdicts in these cases, EEAC's members have a substantial interest in the issue presented for the Court's consideration in this case—*i.e.*, whether the portion of the proceeds of litigation that is paid to a plaintiff's attorney pursuant to a contingent fee agreement is part of that plaintiff's taxable gross income.

EEAC members' interest in this issue is rooted in important, practical concerns. The Court's decision will have a direct and substantial impact on the ability of parties to settle employment discrimination claims. The extent of tax liability has an absolute bearing on the amount of money that the plaintiff ultimately will take home. Since the plaintiff's attorney also will pay income taxes on the portion he or she

receives, making this portion taxable to the plaintiff as well results in double taxation, upping the tax liability and concomitantly raising the amount a plaintiff will need to seek in settlement negotiations in order to take home the desired bottom line. The employers either will be paying the bill, or will decline to settle, so that the ultimate impact will be on the already overburdened federal court system.

Because of its concerns, EEAC over the years has filed *amicus curiae* briefs addressing the issue of taxation of damages in employment law cases.[2] In short, EEAC has a substantial interest in, and familiarity with, the issues and policy concerns presented to the Court in this case. Because of its experience in these matters, EEAC is well-suited to brief the Court on implications of the issues extending beyond the immediate concerns of the parties.

STATEMENT OF THE CASE

No. 03-892. Respondent John W. Banks, II, sued his former employer for employment discrimination under Title VII, 42 U.S.C. § 1981, and state law. Pet. App. 2a. During trial in 1990, the parties settled for $464,000, of which Banks paid $150,000 to his attorneys according to their contingent fee agreement. Pet. App. 4a-5a. Banks did not include any of the settlement in his gross income for 1990. Pet. App. 5a. The Internal Revenue Service (IRS) issued a deficiency notice, and Banks petitioned the U.S. Tax Court for a redetermination. Pet. App. 6a.

Among other things, the Tax Court ruled that the $150,000 contingent fee was taxable income to Banks. Pet. App. 7a. He appealed to the Sixth Circuit. The Sixth Circuit reversed, holding that the portion of a settlement paid to a plaintiff's

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[2] *E.g., Commissioner v. Schleier*, 515 U.S. 323 (1995); *United States v. Burke*, 504 U.S. 229 (1992).

attorney as a contingent fee was not income to the plaintiff. Pet. App. 25a.

No. 03-907. Respondent Sigitas J. Banaitis filed a wrongful discharge case against the Bank of California, his former employer, and Mitsubishi Bank, which owned a controlling interest in the Bank of California. He was represented by attorneys pursuant to a contingent fee agreement. Pet. App. 3a-4a. After trial, the jury awarded him backpay, front pay, and compensatory and punitive damages. Pet. App. 5a. The trial court set aside the punitive damages award and both parties appealed. Banaitis and his lawyers revised their contingent fee agreement, raising the percentage to be paid to the lawyers if successful. *Id.* Near the end of a lengthy appeals process, the parties settled the case. Pet. App. 6a. Mitsubishi Bank cut a check payable to Banaitis, and the Bank of California cut a check payable directly to his lawyers. *Id.* After Banaitis reported only his part of the settlement on his tax return, the IRS issued a deficiency notice, concluding that the amount paid to Banaitis' lawyers was taxable income to him. Pet. App. 7a. The Tax Court agreed, and Banaitis appealed to the Ninth Circuit. Pet. App. 8a. The Ninth Circuit concluded that Oregon law provides an attorney with a lien on a judgment or settlement, and that as a result, the money paid to Banaitis' lawyers was not includable in his gross income. Pet. App. 12a-16a.

The Commissioner of Internal Revenue, represented by the Solicitor General of the United States, petitioned this Court for writs of *certiorari* in both cases. The Court granted both petitions and consolidated the cases for oral argument.

SUMMARY OF ARGUMENT

The Sixth and Ninth Circuits below reached the right conclusion, that the portion of a damages recovery paid to the plaintiff's attorney pursuant to a contingent fee agreement is

not taxable income to the plaintiff. No. 03-892, Pet. App. 25a; No. 03-907, Pet. App. 12a-16a. Although they reached this result using different reasoning, either approach is correct. Before a settlement or verdict, an attorney's fee is only a hope, at most an undefined expectation. Once the settlement or verdict occurs, the proceeds belong in part to the attorney who earned them and the client on whose behalf they were earned, whether dictated by state law, as the Ninth Circuit ruled, or by the nature of the contingency fee, as the Sixth Circuit concluded.

As a practical matter, double taxation of the attorney's contingent fee ratchets up the cost of potential settlements, to the ultimate detriment of plaintiffs, defendant employers, and the courts. Contrary to the Commissioner's argument, this situation indeed *is* double taxation, since two taxpayers are being taxed on the same receipts at the same time. Where the government seeks an extra helping, the plaintiff's counsel has to seek more money in negotiating a settlement in order to bring home the same bottom line. As a result, the potential cost of settlement increases for the employer—who may or may not decide to make the business judgment to hand over the additional funds. If the employer declines, the parties' only remaining choice is to litigate, raising the burden on the plaintiff, the employer, and ultimately, the courts.

ARGUMENT

I. THE SIXTH AND NINTH CIRCUITS RULED CORRECTLY THAT THE PORTION OF A DAMAGES RECOVERY PAID TO A TAXPAYER'S ATTORNEY PURSUANT TO A CONTINGENT FEE AGREEMENT IS NOT INCLUDED IN GROSS INCOME

In each case below, the Court of Appeals properly ruled that the portion of the monetary settlement of a taxpayer's lawsuit against his employer that is paid to his attorney

pursuant to a contingent fee agreement should not be included in the taxpayer's gross income.[3] In *Banaitis*, the Ninth Circuit recognized that state law can vest an attorney with a property interest by virtue of the contingent fee agreement "that cannot be extinguished or discharged by the parties to the action except by payment to the attorney." Pet. App. 16a. In such a case, the Ninth Circuit ruled, the portion of the proceeds of the lawsuit that are payable to the attorney are not includable in the taxpayer's gross income. While it previously had ruled in other cases that contingent fees could be included in gross income, the Ninth Circuit distinguished those cases by highlighting the absence of any state-created property interest. Pet. App. 13a.

The Sixth Circuit approached the analysis from a different direction in *Banks*. While recognizing that a state-created property right can shift title to the attorney's portion of settlement proceeds sufficiently to prevent it from being income to the taxpayer, the Sixth Circuit concluded, as had the Fifth Circuit in *Srivastava v. Commisioner*, 220 F.3d 353, 363-64 (5th Cir. 2000), that the issue did not turn on the presence, absence, or precise language of a state attorney's lien law. Pet. App. 23a. Indeed, the Sixth Circuit reasoned, using a state-by-state approach would offer consistency to neither the court nor to taxpayers. Pet. App. 24a.

Rather, the Sixth Circuit concluded that the *nature* of a contingency fee makes it inappropriate to include that amount in the taxpayer's gross income, based on its previous ruling in *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 856 (6th Cir. 2000). There, the Sixth Circuit readily distinguished the contingency fee situation from this Court's decisions in *Lucas v. Earl*, 281 U.S. 111 (1930) (holding that fees and salary earned by a taxpayer were not

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[3] As outlined in both Petitions, several other courts of appeals have disagreed. E.g., *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001).

rendered taxable only by half by virtue of a contract he had entered into with his wife in which they agreed that any property, income and the like would be held as joint tenants), and *Helvering v. Horst*, 311 U.S. 112 (1940) (holding that a taxpayer's gift of negotiable interest coupons from negotiable bonds to his son, who collected the interest later in the year when they matured, constituted the realization of taxable income to the taxpayer). Unlike those cases, the Sixth Circuit explained:

> (1) the fact that the claim, at the time the contingency fee agreement was signed, was 'an intangible, contingent expectancy,' (2) taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds; (3) no tax-avoidance purpose was at work with the contingency-fee arrangement, as there ostensibly was in *Lucas* and *Horst*, and (4) double taxation would otherwise result by including the contingency fee in taxpayer's income.

Pet. App. 24a (summarizing *Estate of Clarks*, 202 F.3d at 857-58).

Either analysis leads correctly to the conclusion that a plaintiff's attorney's contingent fee is not taxable to the client. Before any recovery is realized, a contingent fee agreement constitutes only a hope of income to the attorney, to be realized only if the attorney's labors result in income to the client. Once there is a settlement or verdict, the proceeds belong in part to the client, on whose behalf they were obtained, and in part to the attorney who obtained them, in an amount established by the contingent fee agreement. Where state law so provides, the portion of the proceeds attributable to the contingent fee in effect is the property of the attorney from the beginning, as the Ninth Circuit ruled. Even absent such a state law, the Sixth Circuit's reasoning—that "[t]he income should be charged to the one who earned it and received it," *Estate of Clarks*, 202 F.3d at 858, is sound.

II. DOUBLE TAXATION OF THE PROCEEDS IN EMPLOYMENT LITIGATION RATCHETS UP THE COST OF SETTLEMENTS, POTENTIALLY INCREASING THE BURDENS OF LITIGATION ON LITIGANTS AND THE COURT SYSTEM

Important public policy considerations also support excluding an attorney's contingent fee from the client's gross income. Double taxation by the government increases the cost of settlements, making them ultimately less likely, to the ultimate detriment of the court system.

A. Taxing the Portion of a Settlement That Represents a Contingent Fee Is Double Taxation, Since Both the Plaintiff and the Plaintiffs' Attorney Will Pay Tax on the Same Dollars Obtained at the Same Time

A contingent fee received by a plaintiff's attorney is, of course, taxable earned income to that attorney. Under the Commissioner's position, some or all of that contingent fee is also taxable to the plaintiff, even though he or she is likely never to see or touch it. The Commissioner's view, that this is somehow *not* double taxation, is erroneous.

While the Internal Revenue Code does allow a successful plaintiff to claim the attorney's fee as a miscellaneous itemized deduction on his or her personal income tax return, 26 U.S.C. § 212, several other provisions limit or even eliminate the extent to which the plaintiff can actually take the deduction. Under 26 U.S.C. § 67, miscellaneous itemized deductions are permitted only to the extent that they exceed 2% of the taxpayer's adjusted gross income. On the other end, 26 U.S.C. § 68 places a cap on itemized deductions for any taxpayer whose adjusted gross income exceeds an

inflation-adjusted "applicable amount,"[4] reducing itemized deductions by 3% of the excess up to a maximum reduction of 80% of itemized deductions.

Moreover, the alternative minimum tax (AMT), 26 U.S.C. § 55, also is likely to affect, if not eliminate, a plaintiff's ability to deduct his attorney's fees from taxable income. "A significant miscellaneous deduction for attorney's fees will often trigger a significant AMT and, thereby, effectively reduce or eliminate the deduction." Jonathan Samel, *Courts Differ on Taxation of Contingent Attorney's Fees: Should the Internal Revenue Service Collect on the Full Amount of a Client Settlement?*, 166 N.J.L.J. 193, 196 (Oct. 15, 2001).

The Commissioner sees no incongruity in getting a double tax dip from the attorney's contingent fee—once from the plaintiff, who likely will never even see it, and also from the attorney, who will pay taxes on the fee as earned income. According to the Government, "double taxation" is quite common, *e.g.*, if an individual earns money at his job and uses it to pay for the services of a plumber, the Internal Revenue Service collects income taxes from both. Brief of the Commissioner at 34.

The Commissioner's example, however, actually illustrates the difference, not the similarity, between the two situations. Where a taxpayer earns income and elects to use it to purchase the services of a plumber, the taxpayer's initial receipt of wages is not dependent upon—or even related to—the fact that he will someday hire a plumber. Rather, the taxpayer's receipt of earned income depends on the terms and conditions of the taxpayer's own employment, the hours he works and the wages he earns. Nor is a portion of the

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[4] The "applicable amount" was $139,500 for 2003. IRS, Tax Law Changes for Individuals, Tax Year 2003, Limit on Itemized Deductions, *available at* http://www.irs.gov/formspubs/article/0,,id=109876,00.html#item_ded_2003

taxpayer's paycheck committed in advance to the plumber, or contingent in any way on the degree of success of the plumber's work.

Here, in contrast, the taxpayer's receipt of funds is tied inextricably to the attorney's work. The attorney will receive a fee only if he or she succeeds in obtaining a monetary settlement or judgment for the taxpayer, and the taxpayer likewise will receive a settlement only if the attorney is successful.

Moreover, unlike a taxpayer who cashes a paycheck and uses some of his earnings to buy a plumber's services, the taxpayer-plaintiff may never even see, much less touch, the contingent fee portion of the settlement proceeds. If the attorney's fee is paid to the attorney by one check, and the balance due the plaintiff in another, the fee will never even have passed through the plaintiff's hands. Similarly, if the check for the entire proceeds is made payable to the attorney alone, for appropriate disbursement, the plaintiff will never have seen the portion representing the attorney's contingent fee. Even where there is a single check, payable to both the plaintiff and his attorney, the plaintiff is likely to catch only a fleeting glimpse of the full amount as he endorses the check before it is whisked into his attorney's escrow account for distribution. Nevertheless, in either case, the employer is required to report the full amount, including the fee, to the IRS on a Form 1099, even though the plaintiff barely touched it if at all. 26 C.F.R. § 1.6041-1(f).[5] Since the fee is taxable income to both the plaintiff and the attorney, the Commis-

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[5] Some employers may be unaware of this requirement, since IRS training materials say that "a Form 1099 is not usually issued to the plaintiff" and suggest that IRS employees comb newspaper articles and courthouse dockets to root out settlements in which the government has not received its share. IRS, Market Segment Specialization Program Guideline, Lawsuit Awards and Settlements, Nov. 2000, *available at* 2000 WL 33171823, at *22.

sioner's interpretation *does* amount to double taxation of the same dollars.

B. Double Taxation of Part of the Settlement Proceeds Inhibits Settlements by Increasing the Cost

The government's insistence on its extra helping has a direct negative practical effect on the settlement of lawsuits, and ultimately, on the already tightly stretched court system. Having to include yet an additional portion for the government in calculating an appropriate settlement demand escalates the plaintiff's counsel's negotiating demand, and raises the stakes for the employer, who may or may not want to pay the additional increment to settle. If not, another jury trial is added to the federal courts' already teeming dockets.

About seventy percent of the lawsuits filed in federal court, including those dealing with employment-related issues, are terminated by settlement. Clermont, Kevin J. & Stewart J. Schwab, *How Employment Discrimination Plaintiffs Fare in Federal Court*, 1 J. Empirical Legal Stud. 429, 440, July 2004. Indeed, Congress passed the Alternative Dispute Resolution Act (ADRA), Pub. L. 105-315, 28 U.S.C. §§ 651–658, in 1998, authorizing the federal courts to use alternative dispute resolution methods, including mediation and other forms of facilitated settlement, in lieu of trial to resolve cases. Obviously, settlements of lawsuits that otherwise would have to be tried substantially reduce the burdens facing the federal courts today. Indeed, with more than a quarter of a million civil cases filed in federal district courts every year[6], any

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[6] Administrative Office of the United States Courts, Table C, U.S. District Courts—Civil Cases Commenced, Terminated, and Pending During the 12-Month Periods Ending December 31, 2000-2003, *available at* http://www.uscourts.gov/library/statisticsalreports.html (Federal Judicial Caseload Statistics 2001, 2002 & 2003).

significant impediment to settlement necessarily will increase the courts' workload substantially.

The double taxation that the Commissioner's position demands is just such an impediment. By requiring plaintiffs and plaintiffs' counsel to pay income tax on the same dollars, the Commissioner's view sets aside an extra helping of each settlement—in addition to those portions already taxable to the plaintiff (such as backpay, and compensatory and punitive damages), IRS Bulletin No. 1996-53, Rev. Rul. 96-65 (Dec. 30, 1996), at 5-6,[7] and to the plaintiff's counsel (the attorney's fee) as a windfall to the government. Absent any other source, the Government's extra bite comes directly from the plaintiff's share.

The net result is an increase in the amount each plaintiff and his or her counsel will seek to negotiate from the defendant employer to resolve the case. In order to take the same amount home, the plaintiff will have to get more from the employer. Indeed, lawyers have warned each other that ignorance of the tax implications of a settlement can have dire consequences, turning a good result into a bad one. Steven I. Adler *et al.*, *Taxation Without Representation: If Tax Implications Are Not Considered When Resolving Employment Claims, A Good Settlement or Judgment Could Turn Sour*, 167 N.J.L.J. 1288 (Mar. 25, 2002).

Thus, in order to reach the same net result, plaintiffs' counsel necessarily must start with a higher settlement demand than they would absent the double taxation problem.

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[7] 26 U.S.C. § 104(a)(2), which lists deductions allowed for compensation for injuries or sickness, exempts "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries or physical sickness;" and thus makes compensatory damages for emotional distress non-excludable from gross income "except to the extent they are damages paid for medical care . . . attributable to emotional distress." Rev. Rul. 96-65, at 6 (emphasis added).

Likewise, if the case indeed is going to settle, they must negotiate from the employer a larger amount. Employers then have two choices—pay the higher amount, or litigate. If the plaintiff's minimum threshold is more than the employer is willing to pay, litigation becomes the only option and another amicable settlement is thwarted.

Double taxation of the contingent fee thus increases the burdens on both litigants and the court system. By boosting the gross cost of settlements to cover the government's double dip, plaintiffs have to ask for more to get the same amount, employers have to pay more if they want to settle, and the courts feel the pinch if the increased cost dooms settlement.

CONCLUSION

For the foregoing reasons, the *amicus curiae* Equal Employment Advisory Council respectfully submits that the decisions below should be affirmed.

Respectfully submitted,

ANN ELIZABETH REESMAN
MCGUINESS NORRIS & WILLIAMS, LLP
1015 Fifteenth Street, N.W.
Suite 1200
Washington, DC 20005
(202) 789-8600

Attorneys for *Amicus Curiae*
Equal Employment Advisory Council

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